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Tankers
Industry Note

No. 11 – CLEAN CONUNDRUM

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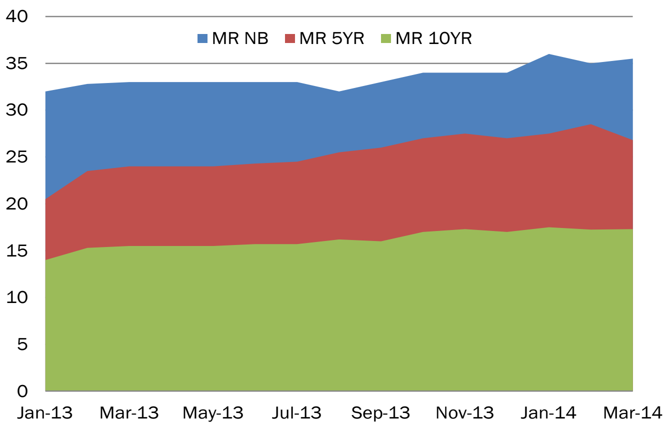
Our previous industry note focused on what may appear to be an asset contango in the VLCC sector. In this note, we discuss observations, current and historical, for the clean tanker market, specifically MR tankers.

In Figure 1, we display the price movements over the last 15 months for MR2 newbuildings, five-year and 10-year old vessels. During this period, we witnessed a sharp increase in five-year old prices (31%) and ten-year old prices (24%) while newbuilding values increased by a modest 11%.

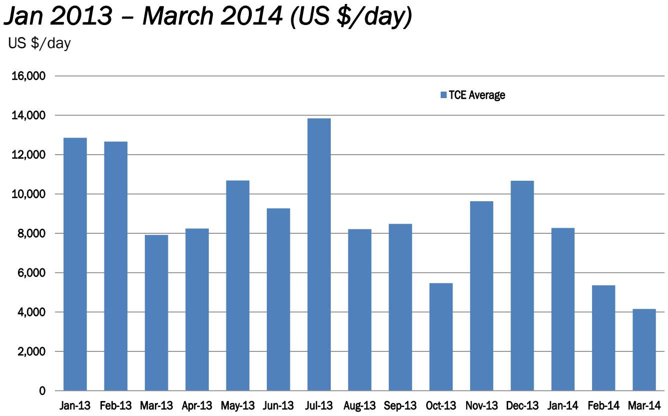
Figure 1: MR2 Tanker Values (NB/5 YR/10 YR)



Source: McQuilling Services

Figure 2 displays the average TCEs for the MR market as calculated by McQuilling since the start of 2013 based on a basket of routes sailing at 13.5 knots using then current bunker prices.

Figure 2: MR TCE Earnings
Jan 2013 – March 2014 (US $/day)

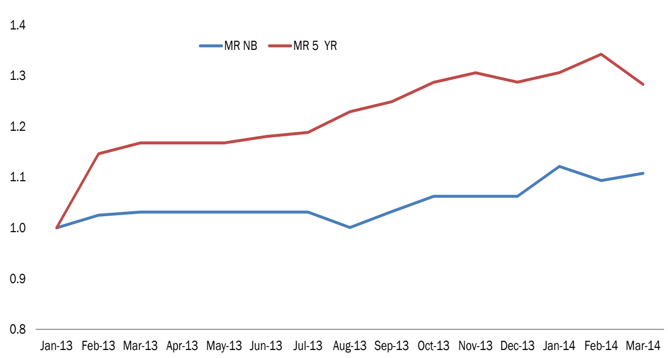


Source: McQuilling Services

Last year began with TCEs above US $12,000/day; however, as the year continued, TCEs declined to under US $10,000/day. In July 2013, we saw a short-term spike to just under US $14,000/day, which may have exacerbated the untimely view that the market was looking to remain positive for the long-haul. However, since hitting the peak, MR2 earnings have come under pressure and are currently hovering at their lowest level in fifteen months (Figure 2). These reduced earnings are also having an impact on asset values; in particular five-year values (Figure 1).

In Figure 3, we display a side-by-side comparison of five-year old and newbuilding values over the last fifteen months. As discussed in our previous industry note, we would expect prices for secondhand tonnage to closely follow movements in TCE levels with newbuilding prices being dictated by the market's future expectations. However, the five-year old asset price trend line increased throughout the year. We believe the conviction displayed by market participants promoting the long-term growth potential in clean products may have led to an impulsive desire to buy up secondhand tonnage despite TCE rates coming under pressure. Reality may however be trickling through as five-year old values have been falling recently.

Figure 3: 5-YR vs. N/B Asset Values
Jan 2013 – Mar 2014 (1.0 – Base)



Source: McQuilling Services

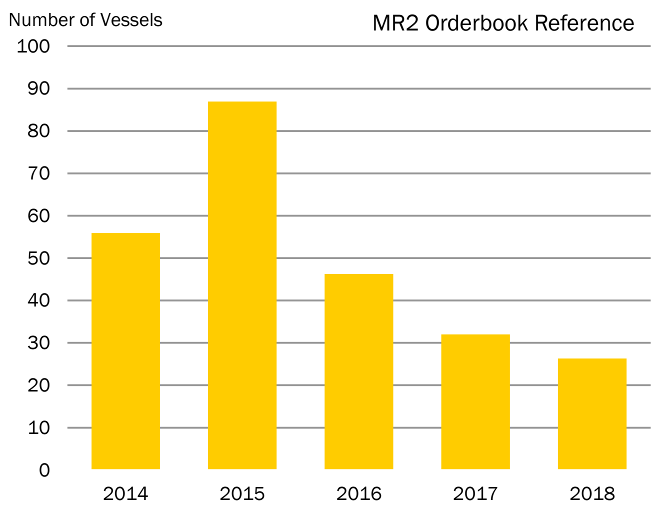
If we conclude that the secondhand asset market is correcting to reflect the weaker TCE results, the question is then whether the future looks any brighter. Is it likely that there will be an asset contango in the MR sector on the horizon?

The long-term CPP tanker demand growth story is in part based on additional refining capacity coming online in Asia and the Middle East coupled with the potential for further refinery closures in Europe. The expectation is that this combination may lead to significant ton-mile demand growth in the coming years and the prospect has propelled owners to build-up their clean tanker fleet via newbuildings.

We examined the orderbook for all tanker sectors and projected the upcoming deliveries in our recently published 2014-2018 Tanker Market Outlook. The orderbook was "grossed up" for future years by taking into account previous year's delivery profiles. Under this scenario, we compare the current orders on record to the average number placed between 2001 and 2013. We use the greater of the two numbers for the basis of deliveries that are assumed in that year.

In Figure 4 below, we illustrate that one of the main challenges to a recovery for MRs in the longer term is the alarming amount of orders placed in the last couple years along with the subsequent delivery profile moving forward.

Figure 4: MR2 Adjusted, Grossed-Up Orderbook
2014-2018



Source: McQuilling Services, Lloyd's Register Fairplay

We accept the notion that significant improvements in the demand/supply fundamentals may lead to a rising asset environment. This was evident during the boom years of 2003-2007 where growth in both advanced economies and emerging markets outpaced vessel supply. However, as a strong, new wave of ordering in these last couple years materializes (Figure 4), we do not envision a re-occurrence, but rather a more likely scenario where newbuilding prices come under pressure until the supply imbalances are removed from the market.

In conclusion, we believe the current MR secondhand asset market will adjust to reflect the weak TCE environment and pressure from a strong delivery profile will strain the optimistic expectations that have been promoted by owners and investors over the longer term.